COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

BAY STATE GAS COMPANY	)	**DTE 01-81**

MASSACHUSETTS DIVISION OF ENERGY RESOURCES' INITIAL BRIEF

Pursuant to 220 CMR 1.11(3), the Massachusetts Division of Energy Resources ("DOER" or "the Division") hereby submits its initial brief in the above referenced proceeding.

Introduction

On October 29, 2001 Bay State Gas Company ("Bay State" or "the Company") filed for approval with the Massachusetts Department of Telecommunications and Energy ("Department") a petition for authorization to establish a Gas Cost Incentive Mechanism ("GCIM" or "proposal"). The intent of the GCIM is to provide financial incentives to encourage the Company to pursue a more aggressive gas supply acquisition strategy that will result in lower gas costs for firm default service customers.[1]

[1] In addition to offering the potential to result in lower gas prices for default service customers, the GCIM has the potential to mitigate price volatility due to the fact that it encourages price

Procedural History

The Department issued a Notice of Public Hearing and Procedural Conference on December 4, 2001. The Notice established an intervention deadline date of December 27, 2001 and scheduled the public hearing and procedural conference on January 3, 2002. DOER, the Attorney General, All Energy Marketing Company, LLC, and the Low Income Assistance Network ("LEAN") all moved to intervene in the proceeding. The Department granted the interventions for all moving parties. Evidentiary hearings commenced on May 6, 2002. On the first scheduled hearing date, a Company witness stated in his opening testimony that the Company was submitting an alternative to the original GCIM proposal.[2] The alternative proposal proffered substantive changes to the original GCIM.[3] As a result, the hearing officer then suspended the hearings and amended the procedural schedule in order to provide at least a minimal due process opportunity to the intervenors, related to the unannounced, significantly modified proposal.[4] Evidentiary hearings based on the modified proposal were conducted on June 19-20, 2002.

Bay State's GCIM

The Bay State proposal is intended to provide incentives to the Company to pursue a more aggressive gas supply acquisition strategy, intended to result in a lower cost gas supply. If realized, the reduced supply

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hedging. In its comments submitted in DTE 01-100, DOER has supported the use of hedging mechanisms to mitigate volatility.

[2] Transcript at 10-11. This information was not provided by the Company until the hearing commenced, compelling substantive changes in the hearing process.

[3] Transcript at 53-54.

[4] Transcript at 51-54.

costs would translate into lower gas commodity prices for the Company's default service customers. The incentive to the Company results from realignment of the risks and rewards associated with a more aggressive supply portfolio management strategy. The proposed allocation of risks/rewards allows the Company and its default service customers to retain specified percentages of net benefits[5] realized through a proactive supply portfolio management strategy that includes the assumption of financial risks associated with both physical and financial hedging strategies. The operation of the proposed GCIM is described below.

The proposal establishes objective commodity price benchmarks[6] for each potential location at which the Company may purchase gas supply.[7] With respect to storage purchases, a benchmark is derived for each supply area that feeds the relevant supply fields according to a specified methodology.[8] Each individual flowing gas commodity purchase and storage purchase is compared to the relevant benchmark.[9] The net gain or loss associated with each specific purchase and associated financial instrument is then determined by subtracting the purchase price from the benchmark price. All the individual net gains and

[5] Net benefits are determined by comparing actual gas purchase prices to an objective published competitive price benchmark.

[6] The primary benchmark for non-storage purchases is derived from *Inside FERC's Gas Market Report.* The default benchmark is derived from *Gas Daily: Monthly Contract Index*.

[7] A $0.0125 reliability premium is added to the benchmark for long-term purchases (over one month in duration). This is a fixed amount applied to all relevant purchases that does not change over the term of the proposed GCIM.

[8] The storage benchmarks are determined according to the methodology described in section 6.09(1)(c) of the Company's amended CGAC Tariff.

losses are then summed at the end of the relevant GCIM period and the total net gains are netted against the total net losses.[10] If the resulting aggregate net value is positive (i.e. net savings), the Company retains 75 percent of the savings and 25 percent of the savings is credited to default service customers.[11] If the aggregate net value is negative (i.e. net loss), the Company is responsible for 100 percent of the losses.[12] Savings that accrue to the Company and its default service customers associated with non-storage purchases are realized in the subsequent corresponding period pursuant to the Cost of Gas Adjustment Clause ("CGAC") Account 175 reconciliation mechanism. Savings associated with storage purchases are realized (pursuant to the CGAC Account 175 reconciliation process) in the peak period subsequent to the peak period immediately following the off-peak period in which storage purchase hedges were made.

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[9] Gains or losses resulting from financial hedges are associated with specific physical purchases and are therefore evaluated relative to the relevant benchmark price applicable to the related physical purchase.

[10] The proposal establishes a peak and off-peak period. The peak period is November-April and the off-peak is May-October.

[11] There is no ceiling relative to the benchmark that limits the customers' total share of net gains.

[12] The fact that the Company absorbs 100 percent of losses if the aggregate net value is negative functionally ensures that default service customers will never pay more than a weighted average benchmark price for all purchases subject to the GCIM. DOER notes that the statement by the Company that default service customers are not impacted/do not share in down side price risks (Exhibit SHB supplemental testimony at p.3, line 12-13) could be misleading. Default service customers are indirectly impacted by GCIM losses and therefore share in the downside risk (Transcript at 131-132). The proposed mechanism aggregates all GCIM gains and losses at the end of a respective period and then nets the gains against the losses. This design reduces the default service customer savings by reducing the net savings before allocating the resulting net savings between the Company and its default service customers.

DOER Position

The risk/reward structure of the proposal provides financial incentives to encourage Bay State to pursue a more aggressive purchasing strategy that caps[13] gas commodity price risks to default service customers, and mitigates such risks with respect to the Company and its shareholders. The 75/25 sharing mechanism of net benefits provides a significant financial incentive to purchase lowest cost commodity. Allocating 100 percent of net losses to the Company and its shareholders provides significant incentives for the Company to enter into lowest cost, prudent portfolio management risks/hedges both from a quantitative and qualitative perspective. Therefore, DOER believes the proposed GCIM has the potential to result in lower commodity costs for Bay State's default service customers[14] and recommends that the Department approve the proposal subject to the modifications described below.

I - The GCIM Should be Limited to the Residential Customer Class

DOER has consistently supported the development of competitive markets in the natural gas industry at the retail level. The Company's proposal has the potential to negatively affect the vitality of existing competition within certain rate classes and to create barriers to the future development of retail competition in Massachusetts, by allowing Bay State to use a market mechanism that creates financial incentives to maintain their existing default service

[13] The de facto cap is equal to the weighted average of the relevant objective published competitive benchmarks used in the GCIM.
[14] Exh. AE 1-7 indicates that over the past three years the Company has paid a total of $527,242 above the relevant proposed GCIM benchmarks. If the Company's proposal had been in effect over this period, default service customers would have benefited due to the fact that shareholders

customer base.[15] Furthermore, given the fact that the Company's financial rewards under the GCIM are directly related to the volume of default service supply procurements, the GCIM provides an incentive to the Company to expand its default service customer base beyond the existing customer base. Incentives to maintain or expand the default service customer base are contrary to the development of competition. Therefore, DOER recommends that application of the GCIM be limited to customer classes that have virtually no competitive supply options.

The only customer class in the Company's service territory to whom competitive suppliers are not actively marketing is the residential customer class.[16] As a result, residential customers have only one product option, default service. Under the current regulatory scheme, Local Distribution Companies ("LDCs") recover default service gas costs via a straight pass-through mechanism, the CGAC. With respect to cost, LDCs are obligated to provide "least cost" gas.[17] In their efforts to comply with this standard LDCs are also subject to a standard of prudence. If an LDC enters into a transaction that has the potential to result in lower gas costs but poses an unacceptable degree of risk (i.e. is "imprudent"), and the transaction results in higher gas costs, the LDC runs the risk of being denied recovery of those costs. While such a scheme

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would have been responsible for any negative (i.e. GCIM seasonal losses greater than seasonal gains) GCIM aggregate net values in each season.

[15] See AllEnergy Ex. 1. See also Transcript at 305-306, 310-311, 342-343.

[16] The lack of competitive opportunities for residential customers, in not only Bay State's service territory, but in Massachusetts in general, is supported by the lack of residential customer migration relative to all other customer classes. This data is presented as an Attachment to this brief in terms of the percentage of the relevant customer classes, and graphically.

[17] See Boston Gas Co. v. Somerville, 420 Mass. 702 (1995).

provides for consistency and reliability of supply, it provides little incentive for an LDC to pursue creative portfolio management strategies for default service. This climate, combined with the fact that the competitive market is not actively marketing to the residential customer class,[18] relegates residential customers to a position where they are, de facto, captive customers that may be required to pay higher gas prices than could be achieved in a more robust competitive market situation. The GCIM, which acts as a proxy for the competitive market, may function to achieve better service (in terms of lower commodity costs) for residential default service customers.[19]

DOER notes that there are other customer classes that have exhibited limited migration to the competitive market.[20] DOER is not recommending application of the GCIM to these customers due to the fact that there are competitive opportunities for these customers. Customers in these markets can take advantage of these opportunities. Residential customers have no available opportunities and therefore the decision of gas suppliers is functionally out of their control.

Furthermore, DOER believes that allowing application of the GCIM to these customer classes could lead to sacrificing a potentially greater benefit, associated with the future development of robust competitive markets, for the

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[18] Testimony of Company witnesses emphatically stated that Bay State had no residential customers served by competitive supply (Transcript vol.2 at 75-76). AllEnergy also stated that it was not serving this customer class (Transcript at 306-307).
[19] It should be noted that AllEnergy stated that it would not oppose the proposal if it were limited to residential customer classes (Transcript at 312, 313).
[20] Small Commercial and Industrial classes. The limited migration data related to these customer classes may be due to limited competitive opportunities.

short term benefit associated with application of the GCIM to default service customers in these classes.[21]

II – The Proposed Reliability Premium Should Be Reduced

The GCIM adds a $0.0125/MMBTU reliability premium (or reservation fee) to the relevant published benchmark price for all long-term commodity purchases (supply contracts with a term greater than one month) made during the period of November-March.[22] The Company stated that the proposed reliability premium is based on the average reliability premium paid over the 2000-2001 peak season.[23] The Department should reject the proposed reliability premium, as it is based on a single season average. The Department should require the Company to amend the proposal to include a reliability premium based on a multi-year historical average of domestic purchases.

The Company's witness testified that the value of a reliability premium is dependent on market conditions.[24] Market conditions can fluctuate significantly thereby resulting in significant yearly variances in reliability premiums/reservation fees. The Company's witness testified that since 1993-94, reservation fees have fluctuated from $0.09 to $0.01-$0.0125 per MMBTU.[25] Furthermore, information provided by the Company indicates that reliability premiums have been lower than $0.01-$0.0125 per MMBTU.[26]

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[21] Competition in these markets has promise as evidenced by slight increases in the relevant migration data. See Transcript at 325. See also Exh. AE 1-4.
[22] See Section 6.09(1)(d) of the modified CGAC Tariff.
[23] See Ex. DOER 1-14. See also Transcript at 98-99.
[24] Transcript at 97-98.
[25] Id.

To mitigate the potentially significant year-to-year fluctuations, the reliability premium should be based on a multi-year average of domestic purchases.[27] Based upon a multi-year average, the cost impacts associated with wide variations in any one year would be appropriately muted. Utilizing a multi-year average is especially important in light of the fact that the proposal is for a three-year term and the proposed reliability premium will be fixed over the term of the GCIM.

Given the three-year term of the proposal, DOER recommends that the Department require that the Company use the most recent three-year historical period for domestic purchases to establish the GCIM reliability premium. The most recent three-year reliability premium average is $0.0084/MMBTU.[28] Therefore, DOER recommends that the Department require the Company to amend the proposal and change the $0.0125/MMBTU reliability premium to $0.0084/MMBTU.

III - GCIM Benefits Should Accrue to Existing Default Service Customers in the Period for which the Respective Transactions were Executed

Under the Company's proposal, actual GCIM results for a particular period will be reflected in Account 175 only at the end of the respective period.[29] Season ending Account 175 balances are realized in the subsequent corresponding period pursuant to the CGAC reconciliation process. The practical result of this design is that any benefits from GCIM transactions

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[26] See Exh. AE 1-16.
[27] The GCIM applies to domestic purchases only (Exh. BSG-1, testimony of F. DaFonte at 4, lines 21-22). Therefore, the multi-year average should be based solely on domestic purchases.
[28] See DOER-RR-2. See also Exh. AE-16.

executed in one period will not be realized until approximately one year later. Furthermore, with respect to the benefits related to GCIM storage transactions, the benefits are not realized until more than one year after the transactions are executed.[30] The reason for the significant delay is that the GCIM postpones aggregation and accounting of all gains and losses until the end of an applicable period. This process practically dictates that the benefits can not be realized during the period for which the transactions were executed.

The GCIM benefits should be credited, to the maximum extent possible, to residential default service customers that consume gas during the period for which the transactions were executed. This will result in the benefits accruing to the existing residential customers as opposed to future customers. DOER recommends that the intra-period GCIM crediting process be administered via existing regulatory procedures in the following manner.

Natural Gas LDCs are required to file intra-seasonal GAFs if a company's *projected* deferred gas cost Account 175 balance at the end of the applicable period is anticipated to be five percent less than or greater than the estimated total seasonal gas costs.[31] The Company should be required to reflect

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[29] Transcript at 116-117.

[30] GCIM storage purchase transactions will be made during the storage fill season (off-peak). The benefits of storage supplies should be realized during the immediately subsequent peak season. Therefore, financial benefits associated with off-peak storage transactions should be realized by customers during the immediately subsequent peak period. This would result in an approximately 0-6 month delay from the time that the transactions were executed. This delay is acceptable given the purpose of storage supplies; to mitigate peak period costs. However, under the GCIM proposal the storage transaction benefits would not be realized by customers until the second peak season subsequent to the off-peak season in which the transactions were executed, an almost 18 month delay.

[31] See DTE 01-49 at 6.

the monthly[32] actual and estimated[33] savings associated with GCIM transactions in its intra-seasonal GAF Account 175 reconciliation forecast analyses. If the intra-seasonal analysis demonstrates that forecast season-ending Account 175 balances exceed the five percent deadband, the Company should file an intra-seasonal GAF, inclusive of all relevant actual and estimated GCIM costs and benefits. This process will allow the GCIM savings/costs to be realized by the residential customers existing at the time the transaction(s) were executed.

The Company witness testified that the proposed GCIM does not provide for intra-period accounting and reconciliation of GCIM benefits and that the Company would be opposed to such a practice.[34] The Company's position is based on the fact that certain financial hedges can not be assigned a specific value due to the open nature of the instrument(s) (valuation of these instruments can not be accomplished until the positions are closed out). The Company argues that because each open financial instrument is tied to a specific physical purchase, the true value of the associated physical transaction is not conclusively established until the open position is closed out. Due to the unknown financial impact of open positions, the Company argues that neither

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[32] The Company stated that the GCIM savings/costs will be tracked and aggregated on a monthly basis but will not be posted to Account 175 until the end of a respective GCIM period. *See Transcript at pp. 116-117*.
[33] Regarding estimated costs/benefits, DOER recommends that only estimated costs/benefits associated with open financial hedges be included in the intra-seasonal reconciliation. The estimated value of these instruments should be based on the relevant futures price.
[34] Transcript at 115-122.

the open instruments nor the associated physical transaction actual gains or losses should be used in an intra-seasonal GAF adjustment.[35]

DOER does not question the validity of the Company's arguments on this issue. However, the Company's arguments do not lead to the conclusion that intra-period accounting and reconciliation of *estimated* GCIM benefits can not be implemented in the context of the proposed GCIM. The fact that the actual value associated with a physical purchase could be impacted by an associated open financial hedge should not prevent the Company from estimating and accounting for expected GCIM gains and/or losses in intra-seasonal GAFs for the following reasons. First, gains and losses associated with actual physical purchases and open financial instruments can be accounted for separately. They are not inextricably intertwined in a manner that would prevent the Company from accounting for each independently. The actual gains or losses associated with physical transactions can be accounted for in an intra-seasonal GAF (see footnote 35), and any future valuation impact of an open financial instrument on the associated physical transaction can be accounted for at the end of the period reconciliation.

Furthermore, open financial positions can be accounted for simultaneously with the associated physical transactions to more accurately reflect the actual value of the physical transaction in an intra-seasonal GAF by *estimating* the value of the associated financial instrument. The Company currently estimates future commodity costs when it prepares an intra-seasonal

[35] The Company stated that it can account for actual gains and/or losses associated with GCIM

GAF analysis and should be able to do so for the relevant open GCIM financial instruments. Differences between the estimated values and the actual values, determined when the positions are closed out, can be reconciled at the end of the period reconciliation. Ultimately, the true value of each GCIM transaction will be accurately accounted for by the Company.

The process outlined above achieves the goal of reflecting GCIM benefits in the most timely manner possible and is consistent with Department policy regarding intra-seasonal GAFs.[36]

IV - GCIM Proposal Clarifications

The GCIM is administered via the CGAC Tariff. The relevant CGAC GCIM language in the Tariff needs to be revised to clarify the issue of transaction cost allocation.

The Company stated that default service customers will not be responsible for GCIM related transaction costs unless the customers' gains offset the relevant costs.[37] However, the relevant GCIM language in the modified CGAC Tariff does not define transaction cost allocation responsibilities.[38] In response to a question regarding the insufficiency of the Tariff language regarding this issue, the Company's witness stated that the operation of the GCIM functionally ensures that customers will only be responsible for transaction costs if the costs are offset by GCIM customer

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physical purchases and incorporate those values in the context of an intra-seasonal GAF (Transcript at 121).

[36] DTE 01-49 mandated intra-seasaonl GAFs be filed by LDCs if the projected costs exceed, or are below, the 5 percent deadband, relative to projected season-ending balances. See DTE 01-49 at 6-7. DOER's recommendation is consistent with this position.

[37] See Exhibit supplemental SHB at pp. 3-4.

gains.[39] Although DOER is not questioning the Company's understanding of the actual effect upon transaction cost allocation responsibility, DOER recommends that the Department require the Company to amend the CGAC Tariff language so that it clearly and unambiguously describes the actual effects of transaction cost allocation responsibility.

V - The GCIM language in the CGAC Tariff should be amended to include language limiting the Company's total hedging activity

DOER recommends that the Department require the addition of specific language in the CGAC tariff limiting the Company's GCIM hedging activity. The Company stated that it would not hedge an amount equal to normal year or normal month requirements due to the possibility that actual requirements may be significantly less than normal.[40] The Company's witness stated that Bay State would limit its hedging to approximately 15-20 percent below normal requirements.[41]

DOER supports the Company's stated commitment to limit its hedging activity below normal year and/or normal month requirements. However, the GCIM CGAC Tariff language does not limit the hedging activities.[42] The hedging activity is limited only by the Company's applicable risk management policies. Corporate policies are not subject to Department approval or regulation.[43] Accordingly, DOER recommends that the Department require the

[38] See CGAC Tariff, section 6.09.
[39] See Transcript at pp. 123-125.
[40] See Exhibit DOER 1-12.
[41] Transcript at 128-129.
[42] See Exhibit BSG 1, CGAC Tariff, Section 6.09. See also Transcript at 129.
[43] Transcript at 129.

Company to incorporate language in the CGAC tariff that specifically limits the Company's GCIM hedging activity. By amending the CGAC to incorporate specific hedging activity limits, the GCIM limits will be subject to Department approval and regulation. Subjecting risk activity limits to Department scrutiny will mitigate risks associated with unreasonable, excessive risk exposure.

The Company stated that its current risk-management policy limits hedging activity to approximately 80 percent of normal year requirements.[44] DOER is not opposing this level but believes that it is at the upper limit with respect to reasonableness in terms of controlling/mitigating risk to customers and shareholders. Given that the risk policy limits are relatively high, DOER recommends that the CGAC Tariff be amended to incorporate the relevant risk policy limits.[45] As stated, this will subject the limits to regulatory oversight to ensure that the associated risks will not be greater than risk associated with the current relevant policy limits.

VI – GCIM Termination Date

The Company is proposing that the GCIM remain in effect for a three-year term. DOER believes that a three-year term is reasonable in terms of monitoring the effect of the GCIM from both the Company's and the Department's perspectives. However, the termination date should be modified to allow for the opportunities for Department review, precipitated by the specific events described above.

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[44] Id.

Specifically, DOER recommends that the Department require the GCIM to terminate on the earliest occurrence of the following: (a) expiration of the proposed three year term; (b) implementation of new base rates resulting from a Company base rate case; or (c) the Department issuance of a decision in the upcoming review of the transition period to a workably competitive natural gas market (as mandated by the Department in 98-32-B). The basis for DOER's recommendation that the termination date be modified, consistent with the above conditions, is described below.

With respect to linking termination of the proposal to the implementation of new base rates, a rate case is the proper forum to determine if any GCIM-related incremental costs have been incurred, exclusive of the transaction costs.[46] If the rate proceeding demonstrates that the GCIM program is not warranted with respect to achieving the anticipated net benefits to residential default service customers, then the GCIM should be terminated at that time. If the rate case proceeding demonstrates that the program is achieving the anticipated benefits for residential customers, then operation of the GCIM should be continued consistent with the three-year term.

With respect to linking termination of the GCIM to the issuance of a Department decision in its upcoming review of the transition period to a workably competitive natural gas market, DOER believes that a complete review/assessment of the effects of the GCIM on competition can occur within the context of the Department's decision in that proceeding. If the relevant

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[45] The language should be consistent with the current risk management policy limits, and the

review demonstrates that the GCIM is impeding the transition to competition in the residential markets, the GCIM may be terminated at that time. If the relevant review demonstrates that the GCIM is achieving the anticipated benefits for residential default service customers and is not impeding the development of competitive markets, then operation of the GCIM should be allowed to continue consistent with the three-year term.

Conclusion

DOER recommends that the Department approve Bay State's GCIM, with the following modifications:

1. The GCIM should be limited in application to the residential customer classes;
2. The reliability premium should be decreased from $0.0125/MMBTU to $0.0084/MMBTU, based on a three-year historical average of domestic purchases;
3. GCIM benefits should be realized by customers in the period for which the respective transactions were executed;
4. The GCIM provisions in the CGAC Tariff should be revised to: (i) unambiguously and accurately describe the actual effects of transaction cost allocation responsibility and (ii) limit the GCIM hedging activity; and,
5. Termination conditions for the GCIM during the three-year term should be flexible, as described in Section VI above.

Company's relevant testimony.

Respectfully submitted,

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[46] DTE-RR-3.

ATTACHMENT – CUSTOMER MIGRATION DATA

Migration data were assembled from LDC data reported monthly, by rate class, to DOER. DOER assembled data from all LDCs, and aggregated them into the customer classes shown in the attached table and graphs. Data shown represents all complete monthly data that is currently available. Due to the similarities in rate class definitions among LDCs, the rate classes shown largely correspond to individual LDC rate classes.